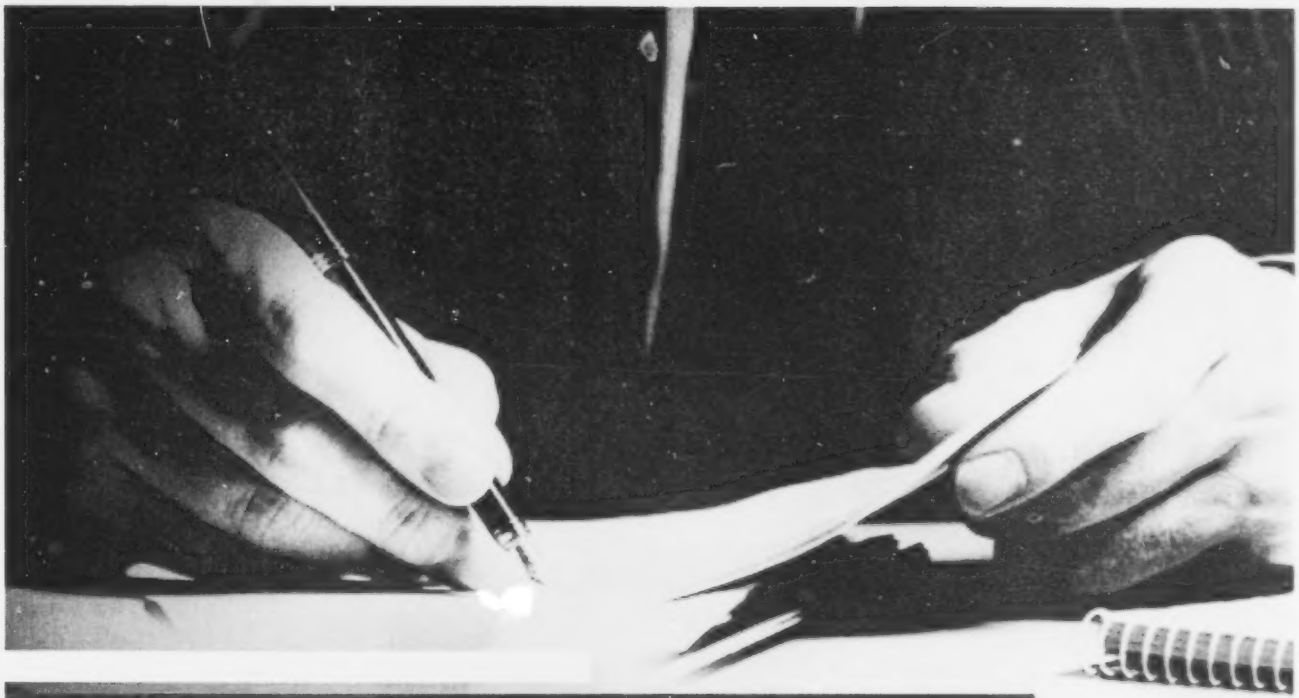

Working Group Report
on the Role of the Québec Government in Venture Capital

The Working Group on the role of the Québec government in venture capital hereby releases its report in accordance with the mandate received on July 10, 2003, from the Québec Minister of Economic and Regional Development, Mr. Michel Audet.

The General Communications and Customer Service Branch of the Ministère du Développement économique et régional coordinated the editing of this report.

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Québec City, December 17, 2003

Mr. Michel Audet
Minister of Economic and Regional Development
Government of Québec
710, place D'Youville, 6e floor
Québec (Québec) G1R 4Y4

Dear Sir:

Last July 10, you requested that I chair the Working Group on the role of the Québec government in venture capital financing.

Today it is my pleasure to send you the Working Group's report.

I would like to take this opportunity to thank the group members, who, I should add, volunteered their time and effort. I would also like to express my appreciation for their invaluable help and their ready availability for the duration of the project.

Sincerely,

Pierre Brunet

Working Group Chair

SUMMARY

THE CURRENT SITUATION

Multiple structures

- Like many other governments, Québec has put in place various organizations to enable it to play a role in financing companies and stay competitive with its closest neighbors.
- The status, role, and financing of these organizations have changed over time. Today, there are 19 of them, each with its own board of directors:
  - The SGF and its 12 subsidiaries, including SOQUIA, SOQUEM, REXFOR, and SOQUIP[1]
  - Investissement Québec and its subsidiary La Financière du Québec
  - The four Innovatech corporations[2]

A costly approach

- Government involvement in financing businesses is a costly endeavor. Over the last ten years from 1993 to 2002, this support totaled over $4.6 billion. Government funding of Investissement Québec, the SGF, and the Innovatech corporations hit $3.6 billion, to which must be added an additional $1 billion in tax credits under labor-sponsored funds and through Desjardins[3].
- This support has been stepped up considerably over the last few years, with almost 80% of the $4.6 billion being handed out between 1998 to 2002, during the second half of this ten-year period.
- The ambitious plans to develop public venture capital corporations have come under the additional strain of recent events, namely the 2000 stock market crash, which placed these corporations in financial straits. The heavy losses they have recorded have placed additional strain on Québec public finances.

1 SOQUIA: Société québécoise d'investissement en agroalimentaire
SOQUEM: Société québécoise d'exploration minière
REXFOR: Société de récupération, d'exploitation et de développement forestiers du Québec
SOQUIP: Société québécoise d'initiatives pétrolières

2 Sociétés Innovatech du Grand Montréal, Innovatech Québec et Chaudière-Appalaches, Innovatech du Sud du Québec, and Innovatech Régions Ressources

3 Fonds de solidarité des travailleurs du Québec, Fondaction CSN, Capital régional et coopératif Desjardins

A predominant role for the public sector

- Over the last few years, the large amounts the Québec government has put into financing businesses have made the public sector a much bigger player in the Québec venture capital market, so much so that it has come to occupy much of the market.
- In 2002, some 70% of venture capital investments in Québec were of a public nature, whether they came from government corporations or were the result of tax measures. The situation is the complete reverse in Ontario, where the rate is about 30%.
- Québec is also distinct from Ontario in that the percentage of foreign venture capital is almost four times less: 10% in Québec as compared to 40% in Ontario.

Specific weaknesses in the financing chain

See illustration in Appendix 1, page 10

- Studies on venture capital in Québec have shown that, despite there being enough capital for all, there are still three specific weaknesses in the business financing chain.
- Even though the government is heavily involved in venture capital, there are two weaknesses in the financing chain for information technology (IT) and health science companies:
    - Financing for companies in the initiation or startup stages
    - Financing for companies that require substantial subsequent rounds of financing (over $20 million) when they reach the expansion stage, which generally corresponds with the product commercialization stage
- There is also a lack of private sector involvement in small projects in outlying regions, which may be explained by the higher risk, elevated transaction costs, and the noticeable involvement of public players. This situation distorts the normal market forces and creates a dynamic that leaves little room for the private sector to grow, in contrast to the clear desire of the regions and their business communities to take things more into their own hands based on their own priorities.

PROPOSED APPROACH AND MEASURES

More targeted government intervention

- To arrive at a better sharing of roles between the private and public sectors in the venture capital market, the Working Group recommends that we proceed like many other industrialized countries in recent years, and break with the current model. This would break the public sector's dominance in the market and allow a new approach whereby the government would play a more targeted role that is more complementary and supportive of the private sector.
- The changes the Working Group is proposing are, in many ways, major ones. If the government agrees to them, it will take a certain amount of time before they can be fully achieved. A transitional period is needed to ensure the change-over goes smoothly and the private sector can come to play a much bigger role.

Simplifying structures

- The current organization of Québec public venture capital corporations, which has resulted in no fewer than 19 distinct entities and as many boards of directors, is a cumbersome and incongruous structure that needs to be simplified in order to streamline it and promote more cohesive action.
- In this vein, the Working Group recommends maintaining only two government corporations dedicated to financing businesses:
    - The SGF, which intervenes mainly by taking equity positions in large-scale projects
    - Investissement Québec, which intervenes mainly by issuing loans and loan guarantees to companies, particularly SMBs
- To this end, the Working Group proposes that the SGF fully incorporate its 12 subsidiaries into its structure, and that La Financière du Québec—an Investissement Québec subsidiary—be dissolved.
- To streamline structures and increase the role of the private sector to guarantee greater market discipline and a level of public support more in line with the government's ability to pay, the Working Group recommends setting up a mixed fund (public and private) specialized in high tech to replace the Innovatech corporations, which, as a result, would be dissolved.

Refocusing the role of the SGF

- The Working Group feels that a corporation like the SGF is a vital tool for economic development, but that a change in direction is needed to restore its portfolio to profitability. As such, the Working Group recommends that the SGF withdraw from projects where its contribution is under $20 million. By doing so, the SGF would no longer be in direct competition with other stakeholders in the market, and could concentrate on large-scale projects, except in the specific sectors of agrifood, forestry, and mining, where it has recognized expertise in smaller-scale projects.
- The Working Group recommends that the SGF implement a five to seven-year divestment plan to free up the necessary liquidity to fully self-finance its activities in the coming years.
- This will lead to substantial government savings over previous SGF projections, which called for some $400 million a year in government outlays for the 2002–2006 period.
- However, the Working Group notes that the SGF expects to need an additional, one-time contribution of $200 million to meet its commitments and eventually be able to self-finance its activities.

Greater emphasis on Investissement Québec's core mission

- In order to limit the public contributions needed to fulfill Investissement Québec's mandate, the Working Group feels that Investissement Québec should focus more on its core mission—to make loans and loan guarantees to businesses, especially SMBs, and intervene in a more targeted way in the FAIRE program, which accounts for an increasingly large percentage of the government contributions currently made to Investissement Québec.
- Moreover, Investissement Québec should take the necessary steps to significantly reduce losses on loans and self-finance its operating costs within four years, which could result in government savings of up to about $25 million a year.

More room for the private sector in high tech

- In order to correct weaknesses identified in the financing chain of IT and health sciences businesses and achieve a more balanced sharing of risk between the private and public sectors, the Working Group recommends that conditions be created to achieve the following:
    - A mixed (private/public) fund specialized in high tech for businesses in the initiation or startup stages of development. Government contributions to this fund should total one dollar for every two dollars in private capital.
    - An entirely private fund for high tech businesses requiring major rounds of financing (over $20 million) once they reach the product commercialization stage.

- The Working Group feels that once the specialized private/public mixed fund is on track, it could require annual government contributions to the tune of $33 million to satisfactorily meet the annual venture capital needs of businesses, estimated at approximately $100 million. A contribution of this order would equal one-third of the 2002–2003 government funding for the four Innovatech corporations, which totaled $99 million.
- In addition, during the transitional period needed to liquidate the current portfolios of the four Innovatech corporations in a gradual and orderly fashion, certain investments could require reinvestment. The sums needed for these reinvestments could total some $80 million over the next three years. However, the Working Group believes that a more in-depth study is needed before a final decision can be made on this issue.

Greater involvement by the regional business community

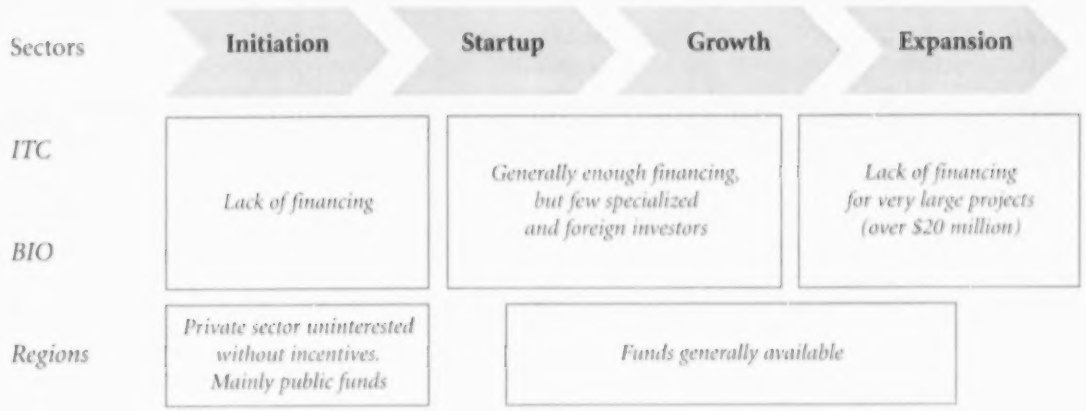
- In order to promote greater involvement by the regional business community in the financing of smaller projects, the Working Group recommends establishing conditions conducive to the creation of publicly and privately funded "regional initiative funds" (RIFs) in all regions of Québec.
- The government would contribute two dollars for every dollar provided by the private sector to create a fund to be managed exclusively by the regional business community. The establishment of an RIF in each of the 17 regions of Québec would ultimately require a government contribution of $34 million, or two-thirds of the total $51 million needed. However, the amounts actually required could be higher, since certain RIFs could be larger, and some regions could have more than one RIF.
- What's more, the Working Group feels that RIF activities could move forward on the same basis as the regional consensuses achieved through the ACCORD project (Concerted Action on Regional Development Cooperation), which used input from the regional business communities to identify regional sectors of excellence.

An *ad hoc* committee on tax incentives and the easing of regulations

- To encourage appropriate and effective participation by the private sector in the three new types of proposed funds, the Working Group feels that it is essential—in light of the experience of numerous countries—to examine the advisability and feasibility of implementing tax measures.
- The Working Group therefore proposes the immediate creation of an *ad hoc* committee composed of representatives from the Ministère des Finances du Québec, the Ministère du Développement économique et régional, and the business community, which would submit concrete proposals to the government in early 2004.
- The *ad hoc* committee could also study the feasibility of easing certain regulations to support the creation of a private IT expansion fund for amounts over $20 million.

APPENDIX 1

SPECIFIC WEAKNESSES IN THE FINANCING CHAIN IN QUÉBEC



ITC: Information and telecommunications technology
BIO: Biotechnologies
Sources: Secor and Ernst & Young

Note: University research enhancement centers are at the very start of the financing chain, before the initiation stage.

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1 THE WORKING GROUP

On July 10, 2003, Québec Minister of Economic and Regional Development Michel Audet announced the creation of a Working Group to examine the role of the Québec government in venture capital. He asked the Working Group to submit its report to him by November 30, 2003.

Makeup

The Working Group was made up of the following people:

Chair	Pierre Brunet	President of the Canadian Institute of Chartered Accountants
Permanent Members	Luc Chabot	President and Chief Operating Officer of Desjardins Venture Capital and President and General Manager of Capital régional and coopératif Desjardins
	Robert Cloutier	President of A. de la Chevrotière Inc.
	Marie-France Poulin	Vice President of Maax inc.
Ad Hoc Participants	Jean Houde	President and CEO of Investissement Québec
	Henri A. Roy	Interim President and CEO of the SGF
	Jean Pronovost	Deputy Minister of Economic and Regional Development (MDER)
Secretary	Marc Leduc	Director of Policies and Entrepreneurship at MDER

The presidents and CEOs of the four Innovatech corporations and the deputy ministers of Agriculture, Fisheries, and Food and of Natural Resources, Wildlife, and Parks also contributed to the Working Group's efforts.

The members of the Working Group acted on a volunteer basis.

MDER provided all administrative and technical support.

Terms of reference

The Working Group was assigned the task of painting an accurate picture of how Québec government venture capital corporations currently operate and formulating recommendations to guide the government in updating their missions and business methods.

The Working Group had to estimate public and private venture capital needs in Québec, identify what role the government needs to play in the market, specify (as the case may be) the adjustments the organizations in question should make, and suggest specific changes to the structures of Québec government venture capital corporations.

Consultation process

After publicly calling for submissions on September 5, 2003, the Working Group received no fewer than 52 briefs from various stakeholders, individuals, private companies, unions, associations, and others. The comments and recommendations contained in these briefs guided the Working Group in its reflections.

Working Group meetings

The Working Group held nine meetings between mid-August 2003 and early December 2003.

At these meetings, the Working Group invited various organizations to make presentations on the situation and challenges of venture capital in Québec and their opinions on the path the industry should take in the coming years. The following organizations participated:

- Government corporations specifically named in the Working Group's terms of reference (i.e., the SGF, Investissement Québec, and the four Innovatech corporations)
- Ministère de l'Agriculture, des Pêcheries et de l'Alimentation and Ministère des Ressources naturelles, de la Faune et des Parcs
- Companies in IT and biotech, including Bio-Québec and Inter Logiq
- Representatives from the venture capital industry, namely T²C² president Bernard Coupal and Réseau Capital president Claude Miron
- Representatives from Fonds de solidarité des travailleurs du Québec (FSTQ)
- Representatives from SECOR and Ernst & Young

2 PRINCIPLES AND ORIENTATIONS

The members of the Working Group would like to touch on a certain number of the principles and orientations that have guided their work and helped them draw up these recommendations.

Venture capital, a key to economic development

It is widely recognized that the venture capital industry plays a pivotal role in innovation and economic development. It is an essential tool for promoting the emergence and growth of companies, notably those in high tech sectors, which make a considerable contribution to modernizing the economy, improving its overall productivity, and creating jobs.

Given the very open nature of the Québec economy and the increasing globalization of markets, developing those sectors of the economy that improve productivity and competitiveness must be viewed as essential to promoting economic growth.

A major but complementary role for government

All industrialized countries have policies and tools to promote economic development. There is no denying that government has a key role to play in financing businesses, particularly in high tech, regional development, small business, and the very specialized and demanding area of major ventures.

However, the government must define its role such that it complements that of the private sector, and confine its activities to fields where the private sector alone cannot adequately meet the needs of industry, particularly due to the high levels of risk.

The government needs to structure its support measures so as to take a more indirect approach, and aim for a leverage effect whereby its assistance is tied to the simultaneous injection of private capital and the placing of management in the hands of the private sector.

Moreover, the structures on which government intervention is based must be streamlined and simplified to promote more unified action and reduce costs.

The roles of the various government players must be redefined to make sure the government is active in every area where public support is needed but without overlap.

Government intervention, and the financial effort it entails, must be carefully targeted to maximize its effectiveness and reduce its cost.

Better risk sharing, for better financing decisions

The government has a definite role to play in venture capital, but it is important that its actions be guided by rules that ensure greater relevance and efficiency.

In this regard, there is need for those who manage government investments to meet minimum performance criteria and, whenever possible, for risk to be shared with the private sector, i.e., the project promoters themselves or private investors. Greater cost and risk sharing with the private sector, whose very survival commands efficiency, is more likely to lead to rational investment decisions.

There must be parameters to guide government intervention so that decisions are based more on business considerations and so that risk is more adequately assumed, in particular by the project promoter. As such, it could be beneficial for the government to provide for specific rules to limit total government assistance.

Room to grow in private sector venture capital

The Québec venture capital industry is young and currently relies heavily on public sector support, and it requires an injection of government funds that is increasingly difficult to justify. A new government approach to venture capital will make room for the private sector and revitalize the Québec venture capital industry to make it better able to face international competition.

What's more, a stronger and more vibrant private sector is sure to attract foreign venture capital, which is currently almost nonexistent in Québec. By teaming up with foreign partners, Québec industry could develop its expertise and become more nimble and cutting edge.

Lastly, as its name suggests, the venture capital industry is by definition a high risk field. In this industry, for every 100 proposals received, 10 are acted on. Of these 10, two will fail, six will struggle along for a while without ever really taking off, and two will be truly successful, giving investors a return on their investments. It is not surprising then that, given the nature of the industry, venture capital has to have higher rates of return to be viable than conventional financing (e.g., bank financing).

A transitional period

The approach recommended by the Working Group encourages the public sector to play a more targeted role in venture capital, and as a result, to support development in the private sector. A transitional period will be needed to bring about this major change in direction, which will entail a significant cultural shift.

3 BACKGROUND

Before addressing the issues facing Québec public venture capital corporations, some background is needed on the special features of Québec government involvement in venture capital endeavors.

Multiple structures

- Like many other governments, Québec has put in place various organizations to enable it to play a role in financing companies and stay competitive with its closest neighbors.
- The status, role, and funding of these organizations have changed over time. Today, there are 19 of them, each with its own board of directors:
  - The SGF and its 12 subsidiaries, including SOQUIA, SOQUEM, REXFOR, and SOQUIP[4]
  - Investissement Québec and its subsidiary La Financière du Québec
  - The four Innovatech corporations[5]

Government support for financing businesses through these organizations could certainly be termed ponderous.

A costly approach

- Government involvement in financing businesses is a costly endeavor. Over the last ten years from 1993 to 2002, this support totaled over $4.6 billion. Government funding of Investissement Québec, the SGF, and the Innovatech corporations hit $3.6 billion, to which must be added an additional $1 billion in tax credits under labor-sponsored funds and through Desjardins[6].
- This support has been stepped up considerably over the last few years, with almost 80% of the $4.6 billion being handed out between 1998 to 2002, during the second half of this ten-year period.
- The ambitious plans to develop public venture capital corporations have come under the additional strain of recent events, namely the 2000 stock market crash, which placed these corporations in financial straits. The heavy losses they have recorded have placed additional strain on Québec public finances.

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5 Sociétés Innovatech du Grand Montréal, Innovatech Québec et Chaudière-Appalaches, Innovatech du Sud du Québec, and Innovatech Régions Ressources

6 Fonds de solidarité des travailleurs du Québec, Fondaction CSN, Capital régional et coopératif Desjardins

QUÉBEC GOVERNMENT INVOLVEMENT IN FINANCING BUSINESSES ($ MILLION)

	Direct intervention			Tax measures	TOTAL
	Investissement Québec	SGF	Innovatech	FSTQ-CSN-Desjardins	
1993-1997	542	83	121	275	**1,021** *(22%)*
1998-2002	1,180	1,300	438	701	**3,619** *(78%)*
Total	**1,722**	**1,383**	**559**	**976**	**4,640** *(100%)*

Sources: SGF and Ministère des Finances du Québec
Detailed data in Appendix 1, page 20

Note: The above table does not take into account other contributions, such as loans to local development funds, operating grants for FTQ regional funds, or recent contributions to funds for women entrepreneurs.

A predominant role for the public sector

- Over the last few years, the large amounts the Québec government has put into financing businesses have made the public sector a much bigger player in the Québec venture capital market, so much so that it has come to occupy much of the market.
- In 2002, some 70% of venture capital investments in Québec were of a public nature, whether they came from government corporations or were the result of tax measures. The situation is the complete reverse in Ontario, where the rate is about 30%.
- Québec is also distinct from Ontario in that the percentage of foreign venture capital is almost four times less: 10% in Québec as compared to 40% in Ontario.

An approach that ignores market rules

Heavy government involvement in the Québec market has led many investors to pursue goals in addition to profitability, mainly job creation and economic development.

This approach flies in the face of normal market rules and makes private and foreign investors much more hesitant and tightfisted, which is natural, given that they prefer experienced fund managers whose goal is to achieve returns.

Specific weaknesses in the financing chain

- Studies on venture capital in Québec have shown that, despite there being enough capital for all, there are still three specific weaknesses in the business financing chain.

IT and health sciences

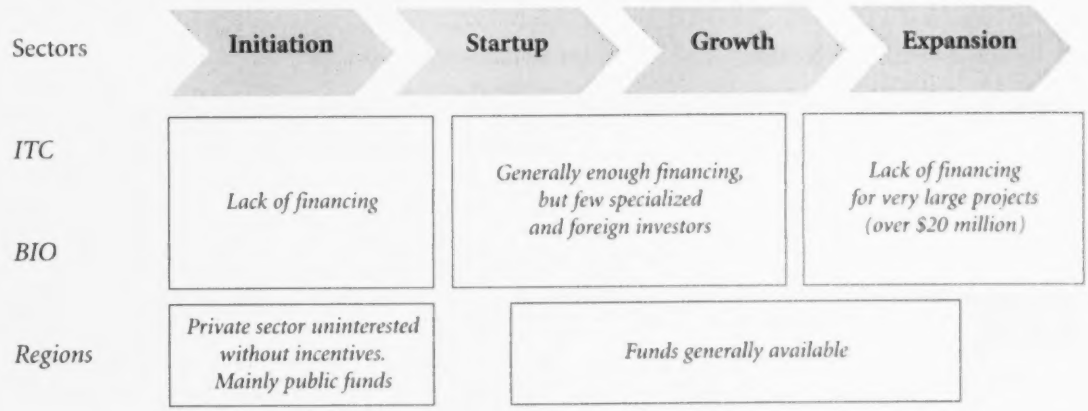
Even though the government is heavily involved in venture capital, there are two weaknesses in the financing chain for information technology (IT) and health science companies:

- Financing for companies in the initiation or startup stages
- Financing for companies that require substantial subsequent rounds of financing (over $20 million) when they reach the product commercialization stage

A desire for greater involvement by the regions

There is also a lack of private sector involvement in small projects in the regions, which may be explained by the higher risk, elevated transaction costs, and the noticeable involvement of public players. This situation distorts the normal market forces and creates a dynamic that leaves little room for the private sector to grow, in contrast to the clear desire of the regions and their business communities to take things more into their own hands based on their own priorities.

SPECIFIC WEAKNESSES IN THE FINANCING CHAIN IN QUÉBEC



ITC: Information and telecommunications technology
BIO: Biotechnologies
Sources: Secor and Ernst & Young

Note: University research enhancement centers are at the very start of the financing chain, before the initiation stage.

APPENDIX 1

QUÉBEC GOVERNMENT SUPPORT TO BUSINESS FINANCING

($ million)

	Direct interventions						Tax measures	Total
			Innovatech					
	Investissement Québec	SGF	du Grand Montréal	Québec et Chaudière-Appalaches	du Sud du Québec	Régions ressources	FSTQ Fondaction CSN Capital régional et coopératif Desjardins	
1993	137	3	18	-	-	-	20	178
1994	130	-	33	3	-	-	54	220
1995	63	-	32	8	-	-	89	192
1996	141	-	19	4	1	-	58	223
1997	71	80	-	-	3	-	54	208
1998	146	50	93	32	8	-	70	399
1999	247	150	35	9	4	8	84	537
2000	263	200	42	11	6	13	113	648
2001	273	700	20	29	19	12	167	1,220
2002	251	200	50	29	10	8	267	815
Total	**1,722**	**1,383**	**342**	**125**	**51**	**41**	**976**	**4,640**

Sources: Direct interventions: Société générale de financement (SGF)
Tax measures: Ministère des Finances du Québec (MFQ)

This table shows Québec government contributions to the main organizations involved in financing businesses. It does not include other contributions such as loans to local development funds, operating grants for regional FTQ funds, or recent contributions to women entrepreneur funds.

4 SOCIÉTÉ GÉNÉRALE DE FINANCEMENT (SGF)

OVERVIEW

Since its inception in 1962, Société générale de financement (SGF) has seen its role and structure change substantially on a number of occasions, with two such changes occurring in 1986 and 1998.

The year 1986 is considered a pivotal year for the SGF, which went from being an industrial holding to a capital-intensive project development corporation that linked up with partners in profit-turning ventures. Its percentage of a company's share capital could no longer exceed 50% but had to be high enough for the SGF to be able to influence the development of the companies in its portfolio.

In 1998, in order to contribute further to the economic development of Québec, the SGF stepped up the pace of its interventions in response to government policy. It adopted an ambitious and well-funded development plan, and brought sectoral government corporations[7] SOQUIA, SOQUEM, REXFOR, and SOQUIP under its wing. These government corporations, while maintaining their own identities, became wholly owned subsidiaries of the SGF.

In the last five fiscal years, the SGF has considerably broadened the scope of its activities as per the directions it received. A number of factors combined to lead the SGF into unfortunate financial waters, and now only a major change of course can turn things around.

SGF activities

Data in Appendix 1, page 27

- Based on its ambitious development objectives, which have created considerable pressure to undertake projects, the SGF has expanded its activities significantly in recent years:
  - A significant investment of funds ($2.5 billion) from 1998 to June 30, 2003, while from 1987 to 1997—a period twice as long—the total amount of funds invested was only $900 million
  - Particularly in 2001 and 2002, investments of over $700 million a year, nearly twice that of the previous two years
  - A rapid increase in the number of companies in the portfolio, which jumped from 28 in late 1997 to 147 by June 30, 2003
  - Numerous memoranda of understanding (MOU) in the pipeline each year, about three per project completed
- This high level of activity has required a major infusion of government funds. Between 1998 and 2002, SGF share subscriptions by the Government of Québec totaled $1.3 billion, with $700 million in the year 2001 alone.

7 SOQUIA: Société québécoise d'investissement en agroalimentaire
SOQUEM: Société québécoise d'exploration minière
REXFOR: Société de récupération, d'exploitation et de développement forestiers du Québec
SOQUIP: Société québécoise d'initiatives pétrolières

Financial results

Data in Appendix 2, page 28

- A major drop in profitability accompanied the increase in SGF activities. The very positive financial results of 1998, 1999, and 2000 gave way to two consecutive annual deficits, $88 million in 2001 and $172 million in 2002. Moreover, the SGF lost some $181 million in the first half of 2003 and expects to post other major losses in the second half.
- In the same way, the rates of return on capital, which were very positive in 1998, 1999, and 2000, turned negative in 2001 and 2002, at -4.3% and -7.3% respectively.
- In 2001 and 2002 as market conditions deteriorated, the SGF had to write off over $250 million—including $172 million for the Magnola plant— and $65 million in high tech investments.
- SGF estimates on the value of its portfolio as at June 30, 2003, indicate that for the $2.635 billion invested, the net book value was $2.157 billion, or about $200 million above the fair market value. The SGF estimates that a precipitated selloff of investments would lead to an additional loss of 20% to 30%.

Rationalization efforts currently under way

- The SGF has taken significant steps to rationalize its operations since last June, including the following main actions:
  - Having the firm Ernst & Young conduct a retrospective investment analysis
  - Tracking its investments in turnaround situations, paying particular attention to commitments it has already made
  - Performing a systematic investment review and portfolio evaluation in conjunction with outside experts
  - Developing a five to seven-year program to roll over its current portfolio
  - Rationalizing the organization and improving its internal procedures
- As part of its rationalization exercise, it conducted an analysis that has led to the following main findings:
  - The SGF's recent poor performance can only partially be explained by the unfavorable market conditions and the marked increase in the Canadian dollar.
  - This poor performance also stems from the fact that the recent emphasis on investment was not backed up with appropriate changes in the corporation's internal structure and management, such that revenues were systematically overrated and costs underestimated. In addition, projects ran into major delays that were not anticipated at the time the decisions to invest were made.
  - One of the biggest problems has also been a lack of expertise and proper organizational structure for investment management, particularly investments in new technologies and SMBs.
  - Lastly, the SGF should be recognized for the unique role it plays in the development, financing, and completion of major industrial projects in Québec; its proactive approach to partnerships; and the scope of its international business network.

OBJECTIVES

- Streamline current SGF structures.
- Uphold the SGF's broad mission of support for the economic development of Québec while refocusing its activities to concentrate on the following areas:
  - Major industrial projects where it has played a unique and recognized role
  - Areas where its business network gives it a structuring influence on the development of promising industrial clusters likely to contribute to Québec's economic growth
  - Areas where industrial projects have a high added value, both economically and technologically
- Move towards an operating mechanism that will quickly make it possible to achieve revenue dependency and, in the medium term, profitability at least equal to its draw on Québec government finances.
- Tie SGF strategies in better with the strategies of Québec government departments active in the same sectors.

SELECTED APPROACH

Taking a whole new path

- After examining the various possible scenarios, the Working Group has dismissed the idea of privatizing the SGF. Doing so would deprive Québec of an important tool for economic development—a tool that a number of countries have also seen fit to acquire. What's more, given the current state of the portfolio and market conditions, short-term privatization would only lead to major losses.
- However, a change of direction is needed to turn the SGF's portfolio around and restore profitability. Moreover, the SGF must refocus on its special and important role in economic development for which it has recognized expertise, i.e., strategic investments with foreign partners in large-scale projects, and in projects to spur the growth of mid-cap companies in Québec.

Streamlined structures

- The sectoral government corporations SOQUIA, SOQUEM, REXFOR, and SOQUIP have been SGF subsidiaries since 1998. These government corporations are active in agrifood, mining, forestry, and oil. Among the reasons for grouping them together is the definite fact that unified management and action make it possible both to avoid unnecessary competition between government organizations—as has been seen all too often in the past—and to continue to benefit from acquired expertise, while ensuring greater cohesion and continuity.
- The Working Group feels that the basic motives for the 1998 amalgamation still exist and there is no reason to go back on this decision. The Working Group even feels it is time to take another step in this direction by fully incorporating these sectoral subsidiaries into the SGF structure to streamline and simplify existing structures. This integration would make it possible to eliminate the 12 public sector companies, including SOQUIA, SOQUEM, REXFOR, and SOQUIP, and streamline the SGF's internal administration.

- That said, the Working Group considers it crucial for government departments and sectoral organizations to be active participants in the planning and decision-making process for SGF activities because they possess solid expertise in their respective fields and an intimate knowledge of the objectives of government intervention that should be used to harmonize SGF strategies with overall government action.
- The incorporating statute[8] of the SGF already makes provision for consultations with the Minister of Economic and Regional Development, the Minister of Agriculture, Fisheries, and Food, and the Minister of Natural Resources, Wildlife and Parks for Québec government approval of the five-year development plan and with the Minister of Economic and Regional Development for approval of the annual operating plan. It should be noted, however, that these consultations have only been held sporadically in the past.
- It would appear wise to strengthen the consultation mechanisms between the SGF and concerned sectoral departments and organizations.

Operating parameters

- In its next five-year (2004–2008) development plan, the Working Group recommends that the SGF apply the following operating parameters in order to improve the performance of its portfolio and gradually move towards revenue dependency to decrease pressure on government funding:
    - A reduced equity or quasi-equity position, not to exceed an average of 20% to 30%, in strategic investments of at least $100 million. The SGF's current average equity position in projects with foreign partners is nearly 40%.

      This parameter signifies that the SGF must invest a minimum of $20 million (20% of $100 million) and ensures that it will continue to play a complementary role to investors further up the financing chain.

      It also enables the SGF to adhere to the criteria requiring that its level of interest in a company allow it to influence the company's orientations, but not make it a majority shareholder.
    - A more hand-picked selection of projects, which will lead to development objectives compatible both with the SGF's mission to seek an acceptable level of profitability and the government's ability to pay.

Financial needs of the SGF

- The Working Group recommends that the SGF implement a five to seven-year divestment plan to free up the necessary liquidity, between $200 million and $300 million a year, to fully self-finance its activities in the coming years.
- This will lead to substantial government savings over previous SGF projections, which called for some $400 million a year in government outlays for the 2002–2006 period.
- However, the Working Group notes that the SGF expects to need an additional, one-time contribution of $200 million to satisfy its commitments and be able to self-finance its activities.

8 This statute also provides for the government to determine the form and scope of the five-year plan and when it must be presented, and for the Minister of Economic and Regional Development to do likewise for the annual operating plan.

PROPOSED MEASURES

Strategic investments, particularly with foreign partners

Continue to proactively identify and initiate large-scale projects requiring SGF investments of at least $20 million and that meet the development needs of industrial sectors, based on an average SGF investment of 20% to 30% in strategic projects of no less than $100 million.

Supporting the growth of mid-cap companies in Québec

Support investment projects (acquisition, aggregation, expansion, and generational transfer) of mid-cap companies in sectors where it has expertise and which require investments of at least $20 million, based on an average SGF equity of 20% to 30% in investments to support no less than $100 million in growth.

Support companies that have experienced management teams likely to generate growth, and that have investment projects aimed at bolstering their competitive position in North American or global markets.

Continuing to provide for smaller investments in the regions, specifically in agrifood, forestry, and mining

Support SMBs in the agrifood, forestry, and mining sectors where the SGF has established expertise and a track record, for investments of over $2 million.

Assist companies wishing to expand their markets.

Support technologies and products that are tested and marketable.

Seek out other sources of financing for these sectors, including partnership arrangements with the private sector in groups of projects or specific individual projects.

Withdrawal from sectors other than agrifood, forestry, and mining for projects under $20 million

In sectors other than agrifood, forestry, and mining, not directly participate in any projects requiring investments of under $20 million.

In the next three years, completely eliminate portfolio investments under $20 million in these other sectors.

During this transitional three-year period, liquidate investments in an orderly fashion and help establish private funding, which will take over from the SGF.

Streamlined structures

Fully incorporate SGF sectoral subsidiaries, including SOQUIA, SOQUEM, REXFOR, and SOQUIP, into the SGF's structure.

Bolster consultation and cooperation mechanisms between the SGF and the sectoral departments and organizations with which it deals to allow them to participate in the planning and decision-making process for SGF intervention in the specific fields of agrifood, forestry, and mining.

Operating parameters

Adopt the following operating parameters in the next five-year (2004–2008) SGF development plan:

- More careful selection of projects, so that investment objectives will be less ambitious
- A level of profitability in keeping with its mission and at least equal to its draw on government funds, to be achieved in the next three years

APPENDIX 1

SGF ACTIVITIES

FUNDS INVESTED BY THE SGF AS AT JUNE 30, 2003 BY SECTOR

Sector	Number of companies	Funds invested $ million	Funds invested %	Average investment per company/$ million
Metals and minerals	32	683	26	21
Chemicals and petrochemicals	18	656	25	36
Technology	20	352	13	18
Health	18	252	9	14
Forestry	19	246	9	13
Agrifood	27	127	5	5
Industrial	8	61	2	8
Corporate	5	299	11	60
TOTAL	**147**	**2,676**	**100**	**18**

Source: SGF

FUNDS INVESTED ANNUALLY ($ MILLION)

	1998	1999	2000	2001	2002
Funds invested *(total in 5 years: $2.310 billion)*	81	383	399	736	711

Source: SGF

Note: From 1998 to June 30, 2003, SGF investments totaled $2.5 billion.

GOVERNMENT CONTRIBUTIONS TO THE SGF, MILLIONS OF $

	1998	1999	2000	2001	2002
Shareholder's capital share subscription *(total $1.3 billion)*	50	150	200	700	200

Source: SGF

APPENDIX 2

FINANCIAL RESULTS OF THE SGF

NET INCOME (NET LOSS) ($ MILLION)

	1998	1999	2000	2001	2002
Operating income (loss), financial expenses, and other earnings	75	46	41	(20)	(69)
Unrealized income (loss) on venture capital investments and loss provisions	(4)	(19)	(23)	(75)	(322)
Realized income (loss) on investments	8	89	31	7	219
Consolidated net income (loss), $ million	**79**	**116**	**49**	**(88)**	**(172)**

Source: SGF

RETURN

	1998	1999	2000	2001	2002
Shareholder's equity	1,245	1,510	1,728	2,332	2,336
Return on shareholder's equity	**6.7%**	**8.4%**	**3.0%**	**(4.3)%**	**(7.4)%**

Source: SGF

PORTFOLIO EVALUATION AS AT JUNE 30, 2003 ($ MILLION)

Sector	Funds invested	Net book value
Chemicals and petrochemicals	626	619
Metals and minerals	660	388
Forestry	253	222
Technology	352	183
Health	255	180
Agrifood	128	173
Industrial	61	48
Subtotal	**2,335**	**1,814**
Corporate	299	343
TOTAL	**2,635**	**2,157**

Source: SGF

5 INVESTISSEMENT QUÉBEC

OVERVIEW

Established in 1998 to replace Société de développement industriel du Québec (SDI), Investissement Québec promotes investment in Québec with a view to fostering economic development and job creation. Its services are primarily oriented toward small and medium-sized businesses (SMBs), which make up over 90% of its clientele. The organization's current mandate covers three main areas: financing, prospecting for foreign investment, and consulting services.

Business financing is Investissement Québec's core mission. It plays a complementary role to financial institutions by backing projects that fail to secure proper financing. Investissement Québec specializes in short-term financing, mainly loan guarantees, but also grants loans. In addition, the organization manages a variety of business financing measures through standardized government programs (FAIRE, Immigrant Investors). Under Section 28 of its incorporating statute, Investissement Québec also responds to occasional special requests from the government regarding initiatives that fall outside the framework of the standardized measures referred to above.

In the area of foreign investment prospecting, Investissement Québec seeks to attract new foreign businesses to Québec and as well as build relationships with established foreign affiliates in order to retain them in the province, encourage reinvestment, and help them secure world mandates.

In the area of consulting, Investissement Québec acts on behalf of the government to oversee certification of businesses applying for fiscal measures (SPEQ, tax credits, etc.). It also provides financial analysis and consulting services to various government departments and, on occasion, to outside organizations, notably under the Immigrant Investors Program that it jointly manages with the private sector. This program is administered under an agreement with the Ministère des Relations avec les citoyens et de l'Immigration.

In fulfilling its mission, Investissement Québec also has the backing of several affiliates, the main one being La Financière du Québec, formerly Garantie-Québec.

Investissement Québec activities

Data in Appendix 1, page 34

- Since its inception, Investissement Québec has grown significantly and steadily expanded its operations. From 1998–1999 to 2002–2003,
  - The number of projects qualifying for financial assistance increased by 45%, from 831 to 1,209
  - Total authorized financing went from $821.4 million to $1,346.7 million, an increase of 64%
- In addition, the value of the projects financed is considerable, nearly $7 billion in 2002–2003. Over the past five years, the leverage effect of Investissement Québec financial interventions has been consistently high, with a project value/authorized financing ratio that has averaged 6 to 1.
- Investissement Québec's performance is analyzed primarily in terms of economic impact, i.e., job creation and tax benefits.

SMB-related activities across Québec

Data in Appendix 2, page 34

- Investissement Québec deals with numerous small and medium-sized businesses through its SMB Financial program, cooperatives and specific programs like SMB Startup and Immigrant Investors. In 2002–2003, Investissement Québec was involved in 1,078 SMB projects representing 89% of its total activities for the year.
- A regional breakdown of Investissement Québec activities shows that the organization is active in all of Québec's regions. In the metropolitan and central regions, the relative weight of Investissement Québec interventions corresponds quite closely to regional economic weight. In outlying regions, however, the relative weight of interventions (16%) significantly outweighs regional economic weight (10%).

Major loan losses

Data in Appendix 3, page 35

- It is normal for an organization like Investissement Québec to record losses on loans to some of the businesses it deals with. Given its economic development mission, such losses can be relatively high.
- Over the past five years, the organization's cumulative rate of projected loan losses has hovered around 20%, which seems high, even for an organization with a mission like that of Investissement Québec. The organization is aware of this situation and plans to take measures to reduce loan loss levels in the future.

Strong government support

Data in Appendix 4, page 36

- Québec government contributions to Investissement Québec have remained stable but very significant at approximately $250 million per year.
- In 2002–2003, the cost of government-mandated interventions was $62.6 million. These were interventions carried out by Investissement Québec at the specific request of the government, as provided for under Section 28 of the organization's incorporating statute.
- It should also be noted that the FAIRE program accounts for a major share of Investissement Québec activities, both in terms of total financing and government expenditures. In 2002–2003, FAIRE accounted for $740 million out of a total of $1,347 million in authorized financing. As for the cost of the program to the government, it is over $181 million out of a gross cost of some $268 million.
- Lastly, the government allocates significant funds for Investissement Québec operating costs. It currently covers two-thirds of these costs, which worked out to $27 million out of $40 million in 2002–2003.

OBJECTIVES

- Streamline Investissement Québec structures.
- Maintain Investissement Québec's overall mission of fostering investment and economic development in all Québec regions, but refocus activities around its core mission, i.e., supporting businesses, especially SMBs, through various types of loans and loan guarantees.
- Identify profitability more clearly as an Investissement Québec management objective and reduce loan losses to a more acceptable level that is in keeping with the government's ability to pay, but does not jeopardize the organization's economic development role.
- Aim for self-financing of operating costs within four years.

SELECTED APPROACH

Incorporation of La Financière du Québec into Investissement Québec

- Incorporate Investissement Québec subsidiary La Financière du Québec and its operations into the parent organization to streamline structures.

Self-financing of operating costs

- Reduce the government's share of operating costs by a cumulative amount of approximately $25 million to achieve self-financing within four years.

Refocus activities

- Concentrate efforts on Investissement Québec's core mission—supporting businesses, especially SMBs, through various types of loans and loan guarantees.
- In addition to Investissement Québec's core mission of providing support through loans, maintain a more targeted and selective approach to management support for special projects (e.g., FAIRE program), given that government financial contributions are currently too high, and will have to be reduced.

Management guidelines

- Adjust approved levels of financing to account for actual risk in order to reduce the overall burden of loan losses.
- Tighten up eligibility requirements for financing to reduce loan losses to a more acceptable level.

Financial needs

- Set annual targets for reducing government contributions to the operating budget in order to achieve operational self-financing within four years.
- Set annual targets for the reduction of government contributions with regard to loan losses, in keeping with new management guidelines aimed at reducing loan loss levels.
- Continue separate tracking of the financial impact of government-mandated Investissement Québec interventions.

New supporting role for regional development

See Chapter 7 for more details

- In keeping with its core mission of providing financial support to SMBs, entrust Investissement Québec with responsibility for setting up the new regional mixed multipurpose funds proposed later in this report:
  - Analyze applications for certification from private companies interested in managing these funds
  - Provide loans to the funds equivalent to projected government contributions
  - Monitor fund activities to ensure they follow government guidelines

PROPOSED MEASURES

- Incorporate La Financière du Québec into Investissement Québec.
- Reduce government contributions to operating costs by a cumulative total of $25 million over four years in view to achieving revenue dependency.
- Focus Investissement Québec activities on its core mission, i.e., supporting businesses through various types of loans and loan guarantees.
- Maintain, to the extent desired by the government, a more carefully targeted complementary role in providing management support for special projects.
- Adjust levels of financing to take account of actual risk.
- Tighten up project eligibility criteria.
- Entrust Investissement Québec with setting up the new regional mixed multipurpose funds.

APPENDIX 1

INVESTISSEMENT QUÉBEC ACTIVITIES

INVESTISSEMENT QUÉBEC ACTIVITIES

	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Number of projects	831	770	929	1,066	1,209
Approved financing, *$ millions (*)*	1.4	588.4	802.6	1,036.0	1,346.7
Value of projects financed, *$M (**)*	4,935.5	3,937.1	5,391.9	4,465.3	6,966.7
Leverage effect *(**)/(*)*	6 to 1	7 to 1	7 to 1	4 to 1	5 to 1

Source: Investissement Québec

APPENDIX 2

BREAKDOWN OF ACTIVITIES

BREAKDOWN OF ACTIVITIES BY CLIENTELE – SMBS VS. MAJOR PROJECTS

2002-2003 Activities	Quantity	%
SMB Financial and cooperatives	634	52
SMB Startup	167	14
Immigrant Investors	155	13
Others	122	10
Subtotal: small and medium-sized businesses	**1,078**	**89**
Major project funding	**131**	**11**
Total	**1,209**	**100**

Source: Investissement Québec

BREAKDOWN OF ACTIVITIES BY REGION

2002-2003 Activities	Quantity	%
01- Bas-Saint-Laurent	40	3.3
02- Saguenay–Lac-Saint-Jean	68	5.6
03- Capitale-Nationale	123	10.2
04- Mauricie	30	2.5
05- Estrie	53	4.4
06- Montréal	326	27.0
07- Outaouais	34	2.8
08- Abitibi-Témiscamingue	20	1.7
09- Côte-Nord	12	1.0
10- Nord-du-Québec	6	0.5
11- Gaspésie–Îles-de-la-Madeleine	19	1.6
12- Chaudière-Appalaches	90	7.4
13- Laval	72	6.0
14- Lanaudière	24	2.0
15- Laurentides	68	5.6
16- Montérégie	195	16.1
17- Centre-du-Québec	29	2.4
Total	**1,209**	**100**

Source: Investissement Québec

	Weight of activities (quantity)	Economic weight of regions (GDP)
Metropolitan regions	60%	62%
Central regions	24%	28%
Outlying regions	16%	10%

Source: Investissement Québec

APPENDIX 3

INVESTISSEMENT QUÉBEC PROJECTED LOSSES, % OF PORTFOLIO

	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
	25.2	17.1	16.9	19.1	19.6

Source: Investissement Québec

APPENDIX 4

GOVERNMENT CONTRIBUTIONS TO INVESTISSEMENT QUÉBEC ($ MILLIONS)

	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
	146.3	246.6	262.7	272.7	252.2

Source: Investissement Québec

GOVERNMENT OF QUÉBEC NET COSTS ($ MILLIONS)

		1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Government share of projected recoverable losses	FAIRE	--	--	15.1	79.4	77.4
	Other	19.9	39.0	(2.2)	20.1	48.1
	Total	**19.9**	**39.0**	**12.9**	**99.5**	**125.5**
Financial incentives assumed by the government	FAIRE	7.1	29.3	61.8	81.8	96.8
	Other	1.8	7.1	1.7	13.1	2.0
	Total	**8.9**	**36.4**	**63.5**	**94.9**	**98.8**
Share of administration costs *(Operating costs)*	FAIRE	--	--	--	--	--
	Other	18.3	23.8	26.0	26.8	27.6
	Total	**18.3**	**23.8**	**26.0**	**26.8**	**27.6**
Other items (share of interest-free loans/risk premiums)	FAIRE	--	--	7.2	9.1	6.9
	Other	39.2	52.7	39.2	15.0	9.3
	Total	**39.2**	**52.7**	**72.4**	**24.1**	**16.2**
Subtotal	FAIRE	7.1	29.3	84.1	170.3	181.1
	Other	79.2	122.6	64.7	75.0	87.0
	Total	**86.3**	**151.9**	**148.8**	**245.3**	**268.1**
Net earnings		(24.0)	(43.5)	(1.6)	(29.4)	(22.6)
Government net cost		**62.3**	**108.4**	**147.2**	**215.9**	**245.5**
Impact: projects and activities		*411.8*	*513.4*	*689.5*	*647.1*	*648.5*
Impact/cost ratio		*6.61*	*4.74*	*4.68*	*3.00*	*2.64*

Source: Investissement Québec

Government net costs shown in the above table have been used to develop an indicator illustrating the relationship between the cost and the economic impact of Investissement Québec activities. However, these impacts and costs do not take into account activities related to projects predating April 1998 or to projects undertaken under the former Canada-Québec agreement or Fonds de développement technologique.

6 INNOVATECH CORPORATIONS

OVERVIEW

Société Innovatech du Grand Montréal was created in 1992. Initially, it was supposed to be the only Innovatech corporation. However, the government then created Société Innovatech Québec et Chaudière-Appalaches in 1994, followed by Société Innovatech Sud du Québec in 1995.

These three corporations, which were initially intended to be temporary, became share capital corporations in 1998, managing renewable funds and pursuing revenue dependency. That same year, the government created Société Innovatech Régions Ressources along the same lines.

As part of their mission, Innovatech corporations have supported the development of numerous Québec businesses, particularly those in the IT and health science sectors in the initiation or startup stages. Over the years, Innovatech corporations have developed scientific and technical expertise that has earned the recognition of the Québec venture capital industry.

Given its market, Société Innovatech Régions Ressources has taken a decidedly different approach from that of the other Innovatech corporations. The lack of a critical mass in the regions to effectively support IT and health science companies has forced it to focus its energies on modernizing traditional business sectors such as industrial technologies. It shares this market niche with a number of private players.

Innovatech activities

Data in Appendix I, page 45

- Through their activities, Innovatech corporations have increased the size of their portfolios from year to year. These now include some 300 businesses, nearly half of which are in the portfolio of Société Innovatech du Grand Montréal.
- Innovatech corporations have arrived at this point by investing almost $500 million over the last five years, or an average of nearly $100 million per year.
- As at March 31, 2003, the value[9] of their portfolios stood at some $316 million.
- This data shows that over the last few years, Innovatech corporations have been called on to play, and have played, a large role in the Québec economy. They have helped spur the development and diversification of an economy that, until recently, was sputtering and in need of stimulation.

9 "Fair value" as defined in the notes to Innovatech annual financial statements.

Financial results

Data in Appendix 2, page 46

- Overall, Innovatech corporations have recorded net losses for the last three years. This downward slide has been accelerating, with the consolidated deficit for 2002–2003 alone hitting over $100 million.
- With the tough economic conditions of the last few years, Innovatech corporations now find themselves in financial straits. One could make the argument that their mission and status as public corporations may have led them to place greater emphasis on economic development than on maximizing return on investments.

  It is worth mentioning that the financial situation of Société Innovatech Régions Ressources differs from that of the other corporations, notably due to the nature of its activities. Each year, it has recorded small surpluses, and its portfolio appears to be in good shape.

Use of public funds

Data in Appendix 3, page 47

- Innovatech corporations require substantial public funds, which has put significant strain on government finances.
- As at March 31, 2003, the share capital issued and paid for by the government on behalf of the Innovatech corporations totaled $559 million. Share subscriptions in 2002–2003 hit $99 million.
- As things currently stand, Innovatech corporations do not seem able to ensure their own financial viability while continuing to operate at an acceptable level of activity without heavy government funding.

Weak private sector involvement

- In hindsight, the ongoing reliance on corporations like Innovatech, which have drawn substantially on public funds, has not proved conducive to strong private sector involvement in venture capital financing for IT and health science companies.
- However, this does not mean that the public sector should withdraw completely from venture capital financing. In fact, it seems clear that the high level of risk associated with financing high tech companies in the initiation or startup stages, as well as the expertise and special skills required to succeed in this area, fully justify government support to the private sector in this respect.

Two specific weaknesses in the venture capital available

Illustration in Appendix 4, page 48

- Recent observations on the venture capital industry in Québec have shown that while there seems to be enough venture capital for growing IT and biotechnology companies, there are still two specific weaknesses in the financing chain:
  - Companies in the initiation or startup stages
  - Companies that require substantial rounds of financing (over $20 million) when they reach the expansion stage, which usually coincides with that of product commercialization

OBJECTIVES

Given the market in which the Innovatech corporations operate, the Working Group believes that the following goals should be pursued:

- Streamline the current structure of Innovatech corporations
- Meet the financing needs of IT and health science companies in the initiation or startup stages to offset deficiencies noted at the start of the financing chain, as well as the needs of companies in expansion mode at the end of the financing chain
- Encourage greater private sector involvement in financing and fund management to relieve the pressure on government finances and foster management practices more in keeping with normal market rules
- Tailor government involvement to complement rather than replace the private sector
- Provide enough time to ease the transition to a bigger role for the private sector and prevent breaks in the financing chain

SELECTED APPROACH

1. A specialized mixed fund for high tech companies in the initiation or startup stages

Given the need to streamline, step up private sector involvement with a view to achieving greater market discipline, and bring public funding into line with the government's ability to pay, the Working Group proposes to create a mixed fund with joint public and private ownership. This fund would specialize in high technology and replace the Innovatech corporations, which would be disbanded.

Because managing such a fund with both IT and health science components requires wide-ranging experience as well as the critical mass to draw capable fund managers, the Working Group proposes to create only a single fund for the entire Québec market.

Create the conditions conducive to developing a specialized mixed fund managed by the private sector

- Provide for the creation of a specialized fund for Québec IT and health science companies in the initiation or startup stages to better meet their needs in areas where financing is lacking.
- Define the thrust of the fund to ensure it complements the university research enhancement centers that support projects in their very first stages, before the initiation stage.
- Set a maximum for fund contributions to prevent direct competition with players later in the financing chain, when financing is readily available.
- Support the fund through public contributions designed to attract private capital at least of equal value, limiting government involvement to addressing only known shortfalls in venture capital financing.
- Establish a financing limit from the outset so that the maximum government support will be known, and that it will not overwhelm the market.
- Allow fund managers to invest outside Québec in return for reciprocal investments of the same amount inside Québec, to diversify private financing sources and enable the fund to establish a foreign business network.
- Entrust fund management to a private limited partnership that has met specific competence and expertise criteria, to ensure efficient fund management.
- Clearly set out the responsibilities of the fund management company, which, as a majority-owned private company, should have a great deal of leeway to define its investment strategy and set up a management team as it sees fit.
- Set out reporting methods and mechanisms to ensure the fund actually operates as intended.

Incentives: the leverage approach

- Financing high tech projects in the initiation or startup stages involves substantial overhead and transaction costs that are too high for the private sector to shoulder without significant government support. The experience of the United States, Israel, New Zealand, the United Kingdom, and others in this regard clearly shows that incentive measures are required to attract private investors to this highly specialized market niche.

  It has been noted that many governments in industrialized countries intervene in this strategic development stage using a leverage approach that ties public capital to incentives and private management of investments, to draw private investors to small projects.

- The Working Group believes there is reason to use a leverage approach, which lends itself especially well to small high tech investments. Given this, the group proposes the following for the specialized mixed fund:
  - The government contributes $1 for each $2 of private capital.
  - The private sector claims all profit, in return for assuming losses in their entirety. For its part, the government would only seek to recover its initial investment and carrying costs, which would substantially increase return for private investors.
  - Further incentives could be offered to the private sector, i.e., the ability to buy out the government's share of a given project under preferential terms. This would allow investors to increase the actual yield of successful projects, with the government recovering only its initial investment, plus a modest return.

- This approach offers the following advantages:
  - It requires less government involvement due to its indirect nature.
  - It encourages the private sector to get involved in high-risk areas, where generally few or no private investors venture without public support.
  - By turning over all profits, it fosters sound management based on judicious project choice, investment in companies with marked potential, and good exit strategy planning.
  - It offers a more results-oriented management style that makes it easier to bring investor goals into line with those of venture capital corporations further down the financing chain, thereby facilitating the handoff to new investors and spurring the development of promising companies.
  - Its operating model is conducive to partnerships with foreign investors, notably American venture capital corporations.

Mechanisms and transition period

- Implementing the Working Group's recommendations will require a transition period to put specific mechanisms in place to smooth the transition from the old to the new system. It will be especially important to minimize temporary problems that could occur while changing systems if there is a lack of financing for deserving projects.
- As the selected approach is to create a specialized mixed fund to replace current Innovatech corporation funds, the following mechanisms should be planned:
  - The creation of the abovementioned fund as soon as possible and the development of a steering committee composed of members chosen by the Minister of Economic and Regional Development, which will be responsible for defining the process by which the management team for the new mixed specialized fund is chosen
  - Management of all current Innovatech assets by a single transition team, with a view to the dissolution of Innovatech corporations shortly after. The transition team will assume all rights and obligations of the Innovatech corporations, including taking over their portfolios. To this end, the team may need to have funds available to reinvest in certain promising companies already in its portfolio.

Innovatech Régions ressources has focused its activities in areas more closely related to modernizing traditional sector companies (industrial technologies), areas in which the private sector is already involved. Its portfolio, unlike that of other Innovatech corporations, thus has few links with high tech companies in initiation or startup situations. On the basis of currently available information, the Working Group thinks that the portfolio should by privatized in the short-term and in its entirety, after the feasibility of doing so has been established.

Financial needs for the next two or three fiscal years

- Based on investments over the last few years by Innovatech corporations (see Appendix 1), Québec IT and health science companies in the initiation or startup stages will require some $100 million in venture capital financing. Under the proposed terms of the new fund, two-thirds of this amount will come from the private sector. The other third will come from the Québec government.
- During the transition period, financing will come from
  - Government money for the new specialized mixed fund, which will invest in new projects
  - Reinvestments in high-potential companies already in the portfolio
- The following table shows the amounts that will likely need to be invested by government and the private sector, allowing for a three-year transition period for the fund to reach a cruising speed of $100 million in investments per year.

FINANCIAL NEEDS OF THE NEW SPECIALIZED MIXED FUND

	2004-2005 Year 1, $ million	2005-2006 Year 2, $ million	2006-2007 Year 3, $ million
Financing needs of companies*	**30**	**70**	**100**
Financing sources			
• Private (2/3)	20	47	67
• Government (1/3)	10	23	33

* *The cruising speed at which the financing needs of companies is met is reached in year three.*

- During the transition period required to liquidate the current portfolios of the Innovatech corporations in a phased, orderly manner, some investments may require reinvestment. This may entail a total amount of some $80 million over the next three years. The Working Group believes a closer examination is necessary before taking a final stance on this point.

2. A private high tech fund for growing companies (financing over $20 million)

- Create a private fund for expanding high tech companies with greater subsequent-round financing needs (over $20 million), to offset deficiencies in the financing chain.

3. *Ad hoc* committee on tax incentives and the easing of regulations

- To encourage the appropriate and effective participation by the private sector in the two proposed funds, the Working Group considers it essential in light of the experience of numerous other countries to examine the advisability and feasibility of implementing tax measures.
- The Working Group therefore proposes the immediate creation of an *ad hoc* committee composed of representatives from Ministère des Finances du Québec, Ministère du Développement économique et régional, and the business community, which would submit concrete proposals to the government in early 2004.
- The *ad hoc* committee could also study the feasibility of easing certain regulations to support the creation of a private high tech expansion fund for amounts over $20 million.

PROPOSED MEASURES

1. A specialized mixed fund for high tech companies in the initiation or startup stages

- Create the conditions conducive to developing a mixed fund for IT and health science companies in the initiation or startup stages
- Manage the fund according to the following parameters:
  - Thrust of the fund focused on the health science and IT sectors
  - Financing companies in the initiation or startup stages
  - Financing Québec companies
  - Maximum contribution of $2.5 million, including reinvestments
  - Fund management through a private limited partnership
  - Possible reciprocity agreement with foreign funds
- Fund incentives:
  - Government support in proportion to private investment ($1 from the government for every $2 from the private sector)
  - Private sector keeps profits in return for covering losses
  - Government recovers only its initial investment, plus a modest return
  - Possibility for the private sector to buy out the government under preferential terms
- Transition mechanisms for creating the specialized mixed fund and dissolving the four Innovatech corporations:
  - A steering committee tasked with making recommendations to the Minister on the fund creation process
  - A transition team that will liquidate the assets in the portfolios of the four Innovatech corporations

2. A private high tech fund for growing companies (financing over $20 million)

- Establish conditions conducive to creating a private financing fund for high tech companies seeking to expand.

3. *Ad hoc* committee on tax incentives and the easing of regulations

- Immediately set up an *ad hoc* committee composed of representatives from the Ministère des Finances du Québec, the Ministère du Développement économique et régional, and the business community to submit concrete proposals to the government in early 2004 on tax measures that would facilitate the creation of the new private high tech funds.
- Ask the *ad hoc* committee to assess the viability of easing certain regulations with a view to encouraging the development of the new private high tech expansion fund that has been proposed.

APPENDIX 1

INNOVATECH CORPORATION ACTIVITIES

NUMBER OF COMPANIES IN THE PORTFOLIO

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	100	113	124	140	138
Québec / Chaudière-Appal.	64	68	86	95	99
Sud du Québec	13	15	16	27	30
Régions ressources	n/a	10	25	31	40
Total	**177**	**206**	**251**	**293**	**307**

Source: Innovatech

AMOUNTS INVESTED IN THE FISCAL YEAR ($ MILLION)

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	46.4	72.8	71.1	78.2	40.1
Québec / Chaudière-Appal.	13.7	14.3	24.7	29.0	28.8
Sud du Québec	4.4	6.1	6.4	14.8	10.9
Régions ressources	n/a	5.0	8.0	13.1	11.9
Total	**64.5**	**95.2**	**110.2**	**135.1**	**91.7**

Source: Innovatech

PORTFOLIO VALUE (JVM) ($ MILLION)

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	184.5	306.4	281.7	248.5	160.6
Québec / Chaudière-Appal.	39.4	56.0	64.6	87.6	95.9
Sud du Québec	7.7	13.5	26.0	29.1	26.7
Régions ressources	n/a	4.9	12.1	24.3	33.2
Total	**231.6**	**380.8**	**384.4**	**389.5**	**316.4**

Source: Innovatech

APPENDIX 2

FINANCIAL RESULTS OF THE INNOVATECH CORPORATIONS

NET INCOME (NET LOSS) ($ MILLION)

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	4.5	6.1	3.1	(39.6)	(79.6)
Québec / Chaudière-Appal.	(3.4)	5.6	(6.6)	(9.5)	(10.9)
Sud du Québec	(0.0)	(1.4)	(4.7)	(2.4)	(10.9)
Régions ressources	n/a	0.1	0.0	0.3	0.2
Total	**1.1**	**10.4**	**(8.2)**	**(51.2)**	**(101.2)**

Source: Innovatech

ACCUMULATED SURPLUS (DEFICIT) AT THE END OF THE FISCAL YEAR ($ MILLION)

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	4.5	10.6	13.6	(26.0)	(105.6)
Québec / Chaudière-Appal.	(3.4)	2.2	(4.4)	(13.9)	(24.8)
Sud du Québec	(0.0)	(1.4)	(6.2)	(8.6)	(19.5)
Régions ressources	n/a	0.4	0.4	0.8	1.0
Total	**1.1**	**11.8**	**3.4**	**(47.7)**	**(148.9)**

Source: Innovatech

APPENDIX 3

GOVERNMENT CONTRIBUTIONS TO INNOVATECH CORPORATIONS

SHARE CAPITAL ISSUED AND PAID AS AT MARCH 31, 2003

Total subscriptions since the constitution of each corporation, $ million

Innovatech corporations	March 31, 2003
Grand Montréal	342
Québec / Chaudière-Appal.	125
Sud du Québec	51
Régions ressources	41
Total	**559**

Source: Innovatech

GOVERNMENT SHARE CAPITAL SUBSCRIPTIONS ($ MILLION)

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	30.0	35.0	42.0	20.0	50.0
Québec / Chaudière-Appal.	11.0	9.0	11.0	28.6	30.0
Sud du Québec	--	3.5	5.6	19.0	11.0
Régions ressources	n/a	8.0	13.0	12.0	8.0
Total	**41.0**	**55.5**	**71.6**	**79.6**	**99.0**

Source: Innovatech

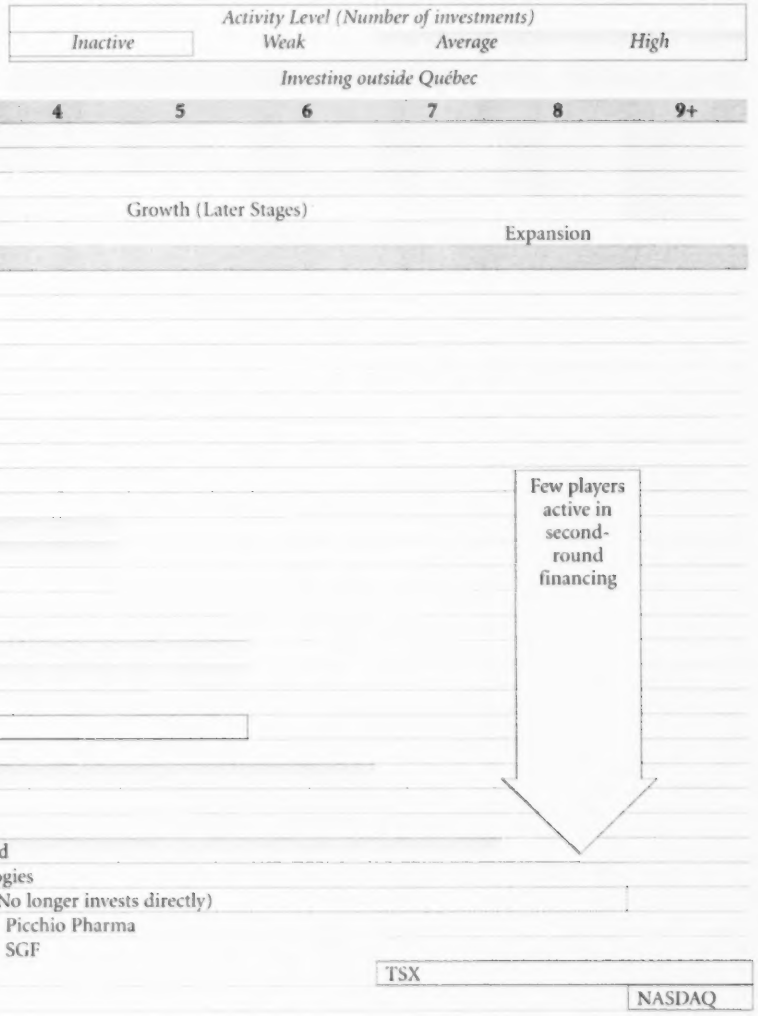
QUÉBEC GOVERNMENT SUBSIDIES ($ MILLION)

Innovatech corporations	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Grand Montréal	0.0	0.0	--	--	--
Québec / Chaudière-Appal.	0.9	0.4	--	--	--
Sud du Québec	0.7	0.8	0.2	--	--
Régions ressources	n/a	0.6	0.9	0.9	0.7
Total	1.6	1.8	1.1	0.9	0.7

Source: Innovatech

Appendix 4

VENTURE CAPITAL MARKET SEGMENTS IN QUÉBEC



Source: Innovatech du Grand Montréal and Secor

7 FINANCING VENTURES IN THE REGIONS

OVERVIEW

Government regional development initiatives touch on a very broad spectrum of interests. They may take any number of forms—encouraging Quebecers to stay in certain regions, maintaining quality public services, supporting communities, or implementing various measures to spur economic development through workforce training, improvements to infrastructures, or assistance to companies or innovative projects.

The specific question of corporate financing in the regions needs to be viewed as just one aspect of many in our regional development initiatives, each of which must be tied into the next to contribute in an effective manner to the continued vitality and economic prosperity of the regions.

With regard to corporate financing in the regions, the Working Group believes that special measures are required, ones that draw synergistically on the unique strengths and particularities of the regions, and especially on the business community, to maximize the impact of government actions. Support measures must be well targeted so that there is no overlap between them, and they do not interfere in areas where the private sector is already doing a good job.

Development capital for the regions

Details in Appendix I, page 55

- The private sector has shown little interest in small-scale financing in the regions. This can be explained not only by the high risk level and considerable transaction costs involved, but also by the large number of public organizations in this market.
- Government development capital available to the regions takes the form of a number of local and regional fund families that are funded themselves primarily through public support measures, either tax incentives or direct contributions.
- This state of affairs skews traditional market rules, leaves little room for the private sector, and runs counter to the desire clearly expressed by the regions and their business leaders to take things more into their own hands and set their own priorities.

Taking a new approach

- While significant government involvement is, without a doubt, necessary to the funding of small and medium-sized businesses in the regions, the Working Group believes that it is essential to spur more active involvement by the private sector, which is currently virtually absent from the scene.
- It is necessary to move away from relying almost solely on the direct injection of public funds and seek instead to promote partnerships with the business communities in those regions that have clearly expressed a desire to take greater charge of their affairs.
- Reexamining our approach in this regard is all the more pressing in view of the fact that, as per the original five-year timeframe established in 1998 for the local investment funds (LIFs), the funds available under this program have now been virtually all loaned to the local development centers (CLDs). These loans will come due starting in 2005.
- This is therefore a good time to remedy the situation and adopt a new approach more in line with those used by other governments that, in varying degrees, now focus on targeted, indirect actions that are less costly in order to promote the emergence of private funds to provide small-scale financing in the regions.

OBJECTIVES

- Provide a flexible, tailored financing tool to address the needs of startup businesses and small-scale business ventures in the regions.
- Make more room for the private sector, notably for business communities in the regions, in terms of both financing and venture capital management, and develop formulas that allow for better and more equitable risk sharing between entrepreneurs and investors.
- Create an environment that encourages a management style more attuned to market forces so as to facilitate handoff from regional business communities to investors further down the financing chain, and thus be a greater support to high-potential businesses throughout their development.

SELECTED APPROACH

Create the right conditions for setting up regional mixed multipurpose funds managed by the private sector—regional initiative funds (RIFs)

- Foster the creation in every region of Québec of RIFs funded by public and private capital and designed to finance small-scale projects for new or existing businesses.
- Given the absence of critical mass in the regions, avoid concentrating these funds in a specific industry, but rather make them multipurpose funds capable of supporting a wide range of businesses that offer good growth and profitability potential. It is to be expected that the sectoral makeup of each of these funds will differ substantially from one region to another.
- Limit fund activities to investments of no more than $300,000, including reinvestments, so as not to compete directly with stakeholders further down the financing chain that already meet market needs.

- In order to offer maximum flexibility and take into account the fact that entrepreneurs are sometimes reticent about sharing ownership of their businesses, authorize fund managers to offer equity, quasi-equity (debentures), or unsecured loans to meet the financial needs of businesses.
- Entrust fund management to local business people who have an insider's knowledge of the industrial makeup of their respective regions, and who also have the network of contacts required to foster the emergence of profitable projects and supervise the development of businesses.
- Set aside at least $3 million per fund to ensure critical operating mass.

Incentive measures: a leverage approach

- It is clear, notably in light of experiences in other countries, that incentive measures adapted to the specific regional context must be implemented if we are to attract private sector players (individuals, companies, and banks) to the financing of small-scale projects in the regions.

  As such, the Working Group has found the approach adopted by a number of industrialized countries (the United States, Israel, New Zealand, the United Kingdom, and others) to be of particular interest. This approach is designed to get the private sector actively involved in the management and financing of regional venture capital funds.

  The Working Group does not propose to simply adopt these models in their entirety for Québec, but rather to take its inspiration from them and adapt them to Québec's institutional situation, while retaining the following guidelines:

  - The government's capital outlay, which would take the form of loans, would be higher than the private sector's investment. For every dollar invested by the private sector, the government would invest $2, up to a predetermined maximum. This would be an attractive financial lever for private investors (individuals, companies, banks, etc.).
  - The private sector alone would share in the profits. The government expects only a minimal return that would allow it to recover its outlay and cover the cost of the funds, which means the financial return for private investors would be substantially higher. However, private investors would assume full liability for any losses.
  - It would also be possible to offer the private sector the option of buying out the government's share in a given project at preferential terms.

- This approach offers multiple benefits:
  - It allows the regional business community to take better charge of its development by becoming involved in the financing of startup companies and small-scale projects.
  - It aids the development of regional financing expertise and support for new companies, and generally encourages more active involvement by the business community, whose respect for market realities ensures that development is more viable and sustainable. This in turn enables the business community to play a bigger role in wealth creation in the region.
  - It spurs the private sector to create regional venture capital corporations to invest in high-risk sectors (startup projects) in which there are generally few or no private investors.
  - It acts as a strong encouragement to investors to be selective in choosing their projects and take an active role in exploiting the potential of businesses and seeing them through to financial independence so as to be able to withdraw their share capital and take full advantage of the government's incentives, i.e., the exclusive right to the profits generated by the venture capital corporation.

- It offers a private management approach more focused on returns than the current model, which is more one of grants, thereby bringing investor missions and objectives more in line with those of other venture capital corporations further down the financing chain. The approach thus facilitates the handoff to private investors further down the financing chain, who in turn can spur high-potential companies on to even greater development.

New regional development support role for Investissement Québec

- Investissement Québec to manage the government's responsibilities with regard to RIF implementation:
  - Analyze applications for certification from private companies interested in creating an RIF
  - Provide the RIFs with loans equivalent to projected government contributions
  - Monitor the RIFs to ensure they follow government guidelines

Ad hoc committee on tax incentives and the easing of regulations

- To encourage appropriate and effective participation by the private sector in the new RIFs, the Working Group considers it is essential—in light of the experience of numerous other countries—to examine the advisability and feasibility of implementing tax measures.
- The Working Group recommends that the *ad hoc* committee it recommended be set up in the previous chapter, and which would include representatives from the Ministère des Finances du Québec, the Ministère du Développement économique et régional, and the business community, also examine the matter of tax measures that could be taken to enhance the appeal of RIFs for potential investors.

Coordinating government initiatives

- It is important to coordinate the actions of the various corporate financing stakeholders in the regions as much as possible and create an environment conducive to the development of partnerships. One way to achieve this would be to attribute complementary roles to each of the key players. Accordingly, the Working Group points out that:
  - Chapter 6 of this report recommends that the government divest itself of the Société Innovatech Régions Ressources portfolio to make more room for other players already actively and effectively meeting needs in the corporation's area of specialty, i.e., the modernization of existing companies in traditional sectors (industrial technology).
  - It would be natural and beneficial for CLDs, as part of their core mission to support entrepreneurs and assist them in defining and implementing their projects, to act as gateways for projects eligible for funding from the RIFs.

- We must also move forward on the same basis as the regional consensuses achieved through the ACCORD project (Concerted Action on Regional Development Cooperation), which used input from the regional business communities to identify regional sectors of excellence. With respect to the ACCORD project, the Working Group would like to stress that:
    - Assuming a partnership with the regional business community, the characteristics of the proposed RIFs seem naturally in keeping with the general thrust of the ACCORD project.
    - The refocusing of SGF activities proposed above leads the Working Group to conclude that MDER would be better suited to the role of providing support and expertise that was slated for the SGF under the terms of the ACCORD project.
    - Development projects started as part of the ACCORD project should make use of the many players already involved in financing companies, whether they are private players, the SGF, Investissement Québec, or RIFs.
- Investissement Québec could also support RIFs in their efforts to attract foreign investors to outlying regions.

Financial needs

- RIFs should have at least $3 million in funding, including $2 million from the government.
- Setting up RIFs in each of Québec's 17 regions would eventually require government contributions of nearly $35 million, or two-thirds of the total $51 million required. However, these amounts could increase if some RIFs are larger and more than one RIF is created in a given region.

PROPOSED MEASURES

- Create the conditions to enable the creation of Regional Initiative Funds (RIFs) in all regions of Québec:
    - If appropriate, there may be more than one RIF in a given region
    - If appropriate, RIFs may be the ones to make certain reinvestments

Manage RIFs according to the following criteria:

- Multiple thrusts
- Financing companies in the region served by the fund
- Financing new or existing companies
- Maximum contribution per project of $300,000 (including reinvestments)
- Fund management through a private limited partnership
- Minimum private sector contribution of $1 million per fund
- Public contributions once the fund is constituted and ready to invest

- RIF incentives:
  - Government support in proportion to private investment
    ($2 from the government for every $1 from the private sector)
  - Private sector keeps profits in return for covering losses
  - Government recovers only its initial investment, plus a modest return
  - Possibility for the private sector to buy out the government under preferential terms
- Creation of RIFs by Investissement Québec
  (Certification, loans, and monitoring of RIF activities)

APPENDIX 1

LOCAL AND REGIONAL "PUBLIC" FUNDS

Québec labor solidarity funds:

Sociétés locales d'investissement dans le développement de l'emploi – SOLIDE: SOLIDE manages an investment fund to help companies create or sustain jobs. Agreements entrust the management of certain SOLIDEs to some 60 local CLDs and some 20 SADCs. Thirty-five SADCs contribute financially to SOLIDE, which provides equity and other loans between $5,000 and $50,000 to companies in the initiation or startup stages.

Regional solidarity funds: The 17 regional solidarity funds provide share capital or loans from $50,000 to $500,000 to companies in the manufacturing and service sectors that are starting up, in the first stages of development, or in a growth or turnaround phase. These funds may even invest up to $750,000 in subsequent-round financing.

Desjardins:

Capital régional et coopératif: With the backing of its parent company's 13 agencies (soon to be 16), Capital régional et coopératif Desjardins invests from $125,000 to $20 million as share capital or bonds in companies in the initiation, startup, growth, or maturity stages in virtually all sectors of activity and all geographic areas in Québec.

Québec government:

Local investment funds (LIFs): Québec has 118 CLDs, which manage the Local Investment Funds (LIFs). These funds have totaled $117 million for the past five years, with $4.7 million available in 2003–2004. CLDs also manage the Young Entrepreneur Fund and the Development Fund for Social Economy Enterprises.

Innovatech Régions ressources: Société Innovatech Régions ressources serves the regions of Abitibi-Témiscamingue, Saguenay—Lac-Saint-Jean, Bas-Saint-Laurent, Gaspésie—Îles-de-la-Madeleine, Côte-Nord, and Nord-du-Québec. It invests mainly in industrial technology sectors. Its portfolio is worth $33 million and includes 40 companies.

Federal government:

Sociétés d'aide au développement des collectivités (SADC): In Québec, there are 57 SADCs (Sociétés d'aide au développement des collectivités) and 10 CAEs (Centres d'aide aux entreprises) in urban centers. SADCs operate independently, providing both consulting and financing services to entrepreneurs. SADCs have an average investment fund of $2.3 million and a youth fund of around $320,000. In addition, to carry out their mission, they can draw on various programs and tools such as youth employment programs and the Community Access Program. SADCs have loaned $140 million to small and medium-sized companies.